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No. 78-1632

In the Supreme Court of the United States  
OCTOBER TERM, 1978

R. M. SMITH, INC., PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO  
THE UNITED STATES COURT OF APPEALS FOR  
THE THIRD CIRCUIT

MEMORANDUM FOR THE RESPONDENT  
IN OPPOSITION

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*Washington, D.C. 20530*

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The sole issue in this federal income tax case is the factual question whether the courts below correctly determined the value of nondepreciable intangible assets acquired by petitioner following the liquidation of a recently purchased subsidiary.

1. The pertinent facts may be summarized as follows: During 1970, petitioner acquired all of the stock of the Gilmour Company for \$3,780,550, to be paid by \$780,550 in cash, a 7-1/2 percent promissory note of \$300,000, and a 4 percent installment note of \$2,700,000. Shortly thereafter, petitioner liquidated Gilmour, so that its basis

in the Gilmour stock became the aggregate basis of the assets in accordance with Section 334(b)(2) of the Internal Revenue Code of 1954 (Pet. App. 21, 94).<sup>1</sup>

Petitioner sought to allocate the purchase price of the Gilmour stock under Section 334(b)(2) and the Regulations<sup>2</sup> as follows: \$1,615,400.19 to depreciable tangible assets, inventory and accounts receivable, and \$1,884,599.81 to patents and an invention. However, petitioner allocated no part of the purchase price to the Gilmour trade name, trademark, goodwill, and going-concern value (Pet. App. 93).<sup>3</sup>

<sup>1</sup>Generally, the basis of property received by the parent in a distribution in complete liquidation of a controlled subsidiary is determined in accordance with the carryover basis rule of Section 334(b)(1). That section provides that the basis of property in the hands of the parent shall be the same as it would be in the hands of the subsidiary. Section 334(b)(2) of the Code, however, is an exception to this general rule. It provides that the basis of property in the hands of the parent shall be determined by reference to the adjusted basis (or cost) of the subsidiary's stock. The exception of Section 334(b)(2) is applicable if at least 80% of the stock of the subsidiary is acquired by "purchase" as defined in Section 334(b)(3), during a period of not more than 12 months, and if the distribution is pursuant to a plan of complete liquidation under Section 332 adopted not more than two years after the purchase.

<sup>2</sup>If the requirements of Section 334(b)(2) are met, Section 1.334-1(c)(4) of the Treasury Regulations on Income Tax (26 C.F.R.) provides that adjustments to the purchase price of the subsidiary's stock shall be made in order to determine the adjusted basis of the subsidiary's stock. The Regulation further provides that after the prescribed adjustments have been made, such amount shall be allocated as basis among the assets received by the parent in proportion to their fair market value.

<sup>3</sup>While the patents and the invention are depreciable intangibles, the trade name, trademark, goodwill, and going-concern value are non-depreciable intangibles. As a result, petitioner's basis allocation maximized its depreciation and amortization deductions.

On its income tax returns for the years in issue, petitioner claimed deductions for amortization with respect to the patents and the invention based upon the above allocation. On audit, the Commissioner of Internal Revenue determined that only one patent had an amortizable basis of \$10,000 and accordingly disallowed petitioner's claimed deductions for amortization to the extent that they were not based upon this amount. In this action instituted by petitioner in the Tax Court (Pet. App. 22, 77), the parties stipulated that the value of the depreciable tangible assets, inventory, accounts receivable and cash that petitioner received in the liquidation was \$1,967,033.52 (Pet. App. 76). The Tax Court found that petitioner received patents and an invention valued at \$860,000 (Pet. App. 90). The Tax Court also found that petitioner received other valuable intangible assets including a trade name, trademark, goodwill, and going-concern value, and concluded that the value of these assets should be determined by the residual method of valuation (Pet. App. 110-111). Applying that method, the Tax Court found that the value of the nondepreciable intangibles petitioner received in the liquidation was \$1,225,697.41. This amount was arrived at by subtracting the \$2,827,033.52 value of all assets (other than non-depreciable intangibles) that were either stipulated by the parties or found by the Tax Court, from \$4,052,730.93, which was the total consideration petitioner paid for the stock (Pet. App. 26, 39-42, 67). The Tax Court then allocated the adjusted purchase price of the Gilmour stock among the assets received by petitioner in the liquidation according to these values (Pet. App. 70). The court of appeals affirmed (Pet. App. 16-33).

2. The courts below correctly found the value of the nondepreciable intangible assets received by petitioner in the liquidation of Gilmour by applying the residual method of valuation. The theory underlying this method of valuation as applied to the lump-sum purchase of tangible and intangible assets is that where the price paid for all assets and the value of all assets (other than nondepreciable intangibles) are both known, the residuum (if any) represents the value of the nondepreciable intangibles. The courts have uniformly held that this method of valuation is a reasonable means of determining the value of nondepreciable intangibles. See, e.g., *Florida Publishing Co. v. Commissioner*, 64 T.C. 269 (1975), aff'd mem., 552 F. 2d 367 (5th Cir. 1977) (Table); *Jack Daniel Distillery v. United States*, 379 F. 2d 569 (Ct. Cl. 1967); *Philadelphia Steel and Iron Corp. v. Commissioner*, 23 T.C.M. 558 (1964), aff'd per curiam, 344 F. 2d 964 (3d Cir. 1965); *Copperhead Coal Co. v. Commissioner*, 17 T.C.M. 30 (1958), aff'd, 272 F. 2d 45 (6th Cir. 1959).

Petitioner contends (Pet. 5-9) that the issue of residual value goodwill was first raised in the Commissioner's posthearing briefs, and that petitioner was thus denied the opportunity to present evidence concerning the value of goodwill. But the Tax Court's holding that the residual method of valuation was appropriate in the circumstances of this case was based on its explicit finding (which was supported by the record) that petitioner had received intangible assets of substantial value upon the liquidation of Gilmour (Pet. App. 110-111). Although petitioner could have presented contrary evidence, it chose not to do so, but elected instead to rely on its theory that nothing was allocable to goodwill. Thus, petitioner cannot now complain that it did not have an adequate opportunity to

present its case with respect to goodwill. Indeed, as the court of appeals noted, the allocation to goodwill of \$1,225,697.41 was "the direct result of the amount fixed in the installment note by the parties to the sale and purchase" (Pet. App. 32 n.5). The court concluded that in these circumstances the parties who deliberately fixed the values to be placed on the elements of this transaction, could not complain of the Commissioner's construction of those values (*ibid.*).

3. Petitioner further contends (Pet. 10-14) that in determining the price paid for the stock for purposes of applying the residual method of valuation, the \$2,700,000 installment note should not have been assigned its face value, but should have been discounted to its fair market value of \$1,990,943<sup>4</sup>. The almost \$800,000 difference between the face value of the note and its asserted market value resulted from a decision of the parties to incorporate this economic or unstated interest into the principal part of the installment note by fixing its interest rate at less than fair market value (Pet. App. 30-31). But as the court of appeals correctly pointed out (Pet. App. 31-32):

The argument in favor of adjustment has intuitive appeal in that greater precision is being used to derive the fair market value of an unknown. However, the effect desired by the taxpayer (increase in bases of depreciable assets) only comes about because less precision is demanded in calculating the basis in the stock. The Internal Revenue Code, 26

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<sup>4</sup>Acceptance of this argument would result in a lower value of intangible assets, and therefore a greater allocation of basis to depreciable assets, resulting in greater depreciation deductions.

U.S.C. §483 (1976), and the underlying regulations, 26 C.F.R. §§483.1-483.2 (1978), require that the treatment of notes for tax purposes be adjusted for unstated interest when the rate assigned is less than four percent. Because the interest rate of the note in question is four percent, no adjustment is required; nor do we believe one is necessary. We hold that both calculations should be made at face value. See *Commissioner of Internal Revenue v. Danielson*, 378 F. 2d 771 (3d Cir. 1967).

It is therefore respectfully submitted that the petition for a writ of certiorari should be denied.

WADE H. McCREE, JR.  
*Solicitor General*

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